No. 15526.

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

SILVER STATE SAVINGS & LOAN ASSOCIATION,

Appellant,

vs.

JAMES CHALMERS YOUNG, Trustor of the Estate of Carver House, Inc. Bankrupt.

Appeal From the United States District Court for the District of Nevada.

APPELLANT'S BRIEF.

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Appeal From the United States District Court for the District of Nevada.

APPELLANT'S BRIEF.

Jurisdiction.

Jurisdiction of the District Court in this proceeding is based on Chapter X of the Bankruptcy Act (11 U. S. C. A. 501-676), the debtor having filed a voluntary petition for reorganization under the provisions of said chapter.

Jurisdiction of this Court on appeal is based upon Section 250 of the Bankruptcy Act (11 U. S. C. A. 650). The appeal is from an order making allowances of compensation to the trustee and the attorney for the trustee and making such allowances a first lien upon all the property of the debtor.

Statement of the Case.

The debtor filed a voluntary petition under Chapter X of the Bankruptcy Act in the United States District Court for the District of Nevada on April 18, 1956. On the same day, the said Court approved *ex parte* the said petition. The debtor had no funds at all [Tr. p. 57, line 6; p. 93, line 15].*

The appellant has at all times held two promissory notes of the debtor, one in the sum of $50,000.00, and the other in the sum of $175,000.00, secured by deeds of trust on the half completed Carver House Hotel owned by the debtor [Tr. p. 25, lines 8-10]. According to the debtor's petition, a trustee's sale of the hotel was scheduled to take place on April 24, 1956, by reason of a default in payment of the $50,000.00 note held by appellant. The order approving the debtor's petition stayed the said sale.

A hearing was held on June 15, 1956, at which time appellant objected to the appointment of the trustee named in the order approving the petition. The objection was on the ground that the said trustee was not a disinterested party [Tr. p. 9, line 23, to p. 10, line 14]. The hearing was continued to July 12, 1956, at which time the Court was advised that the trustee was ill and intended to resign [Tr. p. 15, lines 5-12]. The Court suggested Mr. James Young as a successor, and no objection thereto was made [Tr. p. 15, lines 15-23].

The attorney for the trustee then advised the Court that a plan of reorganization was to have been submitted by July 15, 1956, and the Court set September 17, 1956, as the time for the trustee to present a plan or reasons

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*All references are to pages and lines in the transcript.

why a plan could not be carried out [Tr. p. 15, line 24, to p. 16, line 19].

The September 17, 1956, hearing was changed by the Court to October 4, 1956. At that time the Court stated it was worried because it appeared that the proceeding was developing into a barrier between creditors and the debtor [Tr. p. 20, lines 9-23]. The Court then asked if there was a plan of reorganization [Tr. p. 20, line 23].

The attorney for the trustee stated that there was no plan [Tr. p. 20, lines 24-25; p. 21, line 21]. The trustee advised the Court that he was handicapped because it was one of the most involved operations he had ever been into and there were no records or books available [Tr. p. 22, lines 20-22]. The trustee further advised the Court that the hotel building was under condemnation and that it would be impossible to get liability insurance on the building unless some attempt was made to make the building safe, which would require money [Tr. p. 23, lines 5-14]. He further pointed out that he had no way of finding out where the money the debtor had received had gone, unless he resorted to subpoena procedure [Tr. p. 23, line 14, to p. 24, line 9]. No such procedure was resorted to, nor were any stockholders or officers of the debtor ever examined.

The Court then stated that under the circumstances it would be difficult to reorganize [Tr. p. 24, lines 10-12], and that the best thing to do would be to dismiss the proceedings and adjudicate the debtor a bankrupt [Tr. p. 24, lines 18-20]. The trustee and his attorney stated to the Court that if there was an adjudication, local businessmen who had mechanics liens would be wiped out,

and that they might be protected if there was a plan [Tr. p. 26, lines 5-17, 20-22; p. 27, lines 6-14].

Appellant's counsel then stated to the Court that since the proceeding had been commenced, $18,000.00 worth of doors had been taken from the debtor's building, nothing had been done since the filing of the petition, and requested the Court to adjudicate the debtor a bankrupt [Tr. p. 33, line 23, to p. 34, line 9]. The Court stated that it "didn't know that anyone is seriously urging that there is a possibility of a plan here" [Tr. p. 33, lines 13-15], and stated that a plan should have been filed a long time ago [Tr. p. 34, lines 14-25].

The Court thereupon gave the trustee until November 7, 1956, to file a plan of reorganization [Tr. p. 52, lines 11-15], and set November 20, 1956, as the date for the Court to consider entering an order either adjudging the debtor a bankrupt or dismissing the proceedings [Tr. p. 55, lines 13-17].

On November 20, 1956, the trustee reported that no plan of reorganization could be effected [Tr. p. 63, lines 13-14]. He further reported that he could find no financial records of the debtor, and had been informed and believed none were kept [Tr. p. 63, lines 17-20], that it was doubtful that the hotel building was fifty per cent complete, and it had been under constant threat of condemnation by the City for the last month and presented a serious health and accident problem [Tr. p. 63, line 21, to p. 64, line 4]. The trustee further reported that he was informed and believed that much of the improvements which had been placed on the property, or were on the property for attachment thereto before he qualified, had been either stolen or removed [Tr. p. 64, lines 4-10].

The trustee reported that he was informed and believed

> "that the improvements, such as they were, have materially depreciated and are subject to continued depreciation unless money can be provided forthwith for the protection of the improvements and the property" [Tr. p. 64, lines 10-14].

The trustee also reported that a recent appraisal of the debtor's property and improvements indicated a value of approximately $120,000.00 [Tr. p. 65, lines 2-4], and the debts of the debtor, including the trust deeds held by the appellant, exceeded $450,000.00 [Tr. p. 65, lines 7-11].

However, over the objections of appellant [Tr. p. 79, lines 6-8, 13], the Court continued the hearing until December 4, 1956, because the trustee and his attorney had failed to submit their petitions for allowances [Tr. p. 74, lines 9-16; p. 78, line 25, to p. 79, line 5].

Also, on November 20, 1956, the Court denied appellant's Motion to vacate the order approving the debtor's petition [Tr. p. 68, lines 17-21; p. 73, line 17].

On December 4, 1956, the Court adjudicated the debtor a bankrupt [Tr. p. 104, lines 16-24]. The trustee was awarded an allowance of $1,000.00 [Tr. p. 93, lines 11-14]. The attorney for the trustee was awarded the sum of $250.00 [Tr. p. 102, lines 1-3]. The Court ordered the allowances to the trustee and his attorney to be preferred claims over all secured claims [Tr. p. 102, lines 12-15]. The appellant objected to such preference [Tr. p. 102, line 22].

An order directing the said allowances and making them prior liens was entered by the Court on January 24, 1957.

Thereafter, and on February 28, 1957, a Petition for Leave to Appeal and Brief in support thereof was filed in this Court. On March 4, 1957, an order was entered granting the said petition. On March 16, 1957, a Motion for Leave to File Typewritten Transcripts was filed, and by letter dated April 12, 1957, appellant was advised that the said motion was approved.

Specification of Errors.

1. The Court below erred in making the allowances to the trustee and the attorney for the trustee a first lien upon the real property of the debtor.

Summary of Argument.

The allowances to a trustee and his attorney in an abortive Chapter X reorganization proceeding should be made a lien superior to that of a secured lienholder on real property having no equity, particularly where the proceedings were delayed due to requests of the trustee, who never presented any plan of reorganization, the debtor was hopelessly insolvent, the secured lienholder objected to the proceedings, and the security of the lienholder was impaired during the course of the proceedings.

ARGUMENT.

Administration Expenses in an Abortive Reorganization Proceeding Should Not Be Made a Lien on a Debtor's Real Property Superior to That of a Holder of a Trust Deed Thereon.

There appears to be no precise authority in this Circuit on the issue here presented. However, in *In re Williams Estate,* 156 Fed. 934, 939 (1907), this Court held that the general costs of the administration of a bankrupt estate, such as the general fees of the trustee and his attorney, were not payable out of the proceeds of a sale of liened property, where the proceeds of the sale were less than the amount of the liens. The Court there said that the proceeds

> ". . . are not chargeable with the general costs of the administration of the bankrupt's estate, such as the services of a receiver in carrying on the business of the bankrupt, the expenses and losses of such business, the fees of the attorney for such receiver, the general fees of the trustee or those of his attorney. If so, the valid lien upon the estate of the bankrupt, which the bankruptcy act expressly declares shall be unaffected by any of its provisions, might very readily be destroyed, as it would unquestionably be, should such costs equal or exceeds the proceeds of the entire estate of the bankrupt. In line with this ruling are the cases of Stewart v. Platt, 101 U. S. 731, 739, 25 L. Ed. 816; *In re* Utt, 105 Fed. 754, 45 C. C. A. 32; *In re* Prince & Walter (D. C.), 131 Fed. 546, 552; *In re* Bourlier Cornice & Roofing Co. (D. C.), 133 Fed. 958, 963; Loveland on Bankruptcy (3d Ed.), p. 775. See, also, Collier on Bankruptcy (6th Ed.), p. 497."

In *Duparquet v. Evans,* 80 L. Ed. 591, 595, 297 U. S. 216, 222, 223, the Supreme Court stated that under 77B of the Bankruptcy Act, "at times the holder of the lien may have his security modified or reduced by the plan of reorganization when finally approved." As authority therefor the Court cited *Louisville Joint Stock Land Bank v. Radford,* 295 U. S. 555, 585; 79 L. Ed. 1593, 1602; 97 A. L. R. 1106; and *Continental Illinois National Bank & T. Co. v. Chicago, R.I. & P. R. Co.,* 294 U. S. 675-677, 79 L. Ed. 1127-1129.

In the *Louisville* case, the Supreme Court struck down on due process grounds provisions of the bankruptcy act which affected the rights of mortgagees. In its decision, the Court after tracing some of the history of the bankruptcy, said as follows (295 U. S. at 583, 79 L. Ed. at 1601):

> "No bankruptcy act had undertaken to modify in the interest of either the debtor or other creditors any substantive right of the holder of a mortgage valid under federal law. Supervening bankruptcy had, in the interest of other creditors, affected in some respects the remedies available to lien holders. In Continental Illinois Nat. Bank & T. Co. v. Chicago, R.I. & P. R. Co., 294 U. S. 648, 79 L. Ed. 1110, 55 S. Ct. 595, where, in a proceeding for reorganization of a railroad under section 77 of the Bankruptcy Act, the District Court was held to have the power to enjoin temporarily the sale of pledged securities, this Court said: 'The injunction here in no way impairs the lien, or disturbs the preferred rank of the pledges. It does no more than suspend the enforcement of the lien by a sale of the collateral pending further action. It may be, as suggested, that during the period of restraint the collateral will

decline in value; but the same may be said in respect of an injunction against the sale of real estate upon foreclosure of a mortgage; and such an injunction may issue in an ordinary proceeding in bankruptcy, Straton v. New, 283 U. S. 318, 321, 75 L. Ed. 1060, 1088, 51 S. Ct. 465, 17 Am. Bank. Rep. (N. S.) 630, and cases cited.' (29 U. S. 676, 677.) 'The injunction here goes no further than to delay the enforcement of the contract. It affects only the remedy.' (294 U. S. 681.)"

The *Duparquet* case, *supra,* has been held by the Seventh Circuit to preclude the very action taken by the Court below in the case at bar. In the case of *In re Freeport Standard Dairy Corporation,* 124 F. 2d 783, 784, the Court of Appeals for that circuit affirmed a district court's refusal to make fees of a trustee and his attorney a lien prior to that of a mortgage lien where no plan of reorganization has been filed.

"The only question presented in this summary appeal is whether or not the District Court erred in refusing to subject the mortgaged real estate to the payment of the compensation allowed for the services of the trustee, his attorney, and the attorney for the debtor in the reorganization proceedings."

". . .

"In considering this precise question under 77B, 11 U. S. C. A. §207, proceedings, this Court said: 'Duparquet Co. v. Evans, 297 U. S. 216, 56 S. Ct. 412, 80 L. Ed. 591, seems to leave no doubt that a mortgage lien may not be impaired in a 77B proceeding before a final plan of reorganization has been approved.' *In re* Forty-One Thirty-Six Wilcox Bldg. Corporation, 7 Cir., 100 F. 2d 588, 593.

> "See, also, Louisville Title Mortgage Company v. Louisville Storage Company, 6 Cir., 93 F. 2d 1008, affirming *In re* Louisville Storage Company, D. C., 21 F. Supp. 897; 8 C. J. S. Bankruptcy §872.
>
> "The Chandler Act, providing a complete method of procedure in the reorganization of corporations in bankruptcy, has not changed this rule."

And in 1946, the Seventh Circuit, in the case of *In re Sheridan View Bldg. Corporation,* 154 F. 2d 1008, 1009, quoting from *In re Forty-One Thirty-Six Wilcox Bldg. Corp.* (7 Cir.), 100 Fed. 588, said

> " 'We are forced to conclude in view of such authorities that a court is without right to allow fees or expenses except where they have been earned or incurred in connection with the formation of a plan of reorganization which has been theoretically at least, of benefit to all parties in interest.' "

The Second Circuit has had occasion to consider the point here involved. *In re Franklin Garden Apartments,* 124 F. 2d 451, 454, was a reorganization proceeding in which the mortgagee had taken possession of the corporate debtor's property under the terms of the mortgage which provided for the assignment of rents in case of default. In authorizing the use of the rentals by the trustee to pay current operating expenses only and not administration expenses, the Court said:

> ". . . there seems no justification for allowing them at the present time, or indeed for allowing them at any time, out of the security belonging to the mortgagee, except insofar as the mortgaged property has received benefit through the proceeding (Randolph v. Scruggs, 190 U. S. 533, 23 S. Ct. 710,

47 L. Ed. 1165; *In re* Centralia Refining Co., D. C. Ill., 35 F. Supp. 599, 602), or the mortgagee's rights are fully secured.' "

The *Centralia* case quoted by the Second Circuit in the *Franklin* case, is similar to the instant case. The debtor petitioned for reorganization. Its petition was approved and a trustee appointed. No plan was approved and the corporation was adjudged a bankrupt. The Court there held that administration expenses were not chargeable against the liened property, saying at 35 Fed. Supp. 599, 602, the following:

> "I am aware that this decision will work hardship upon innocent officers and appointees of the Court in the reorganization proceedings. This is to be regretted but there seems to be no lawful alternative. It must stand as warning to court, counsel and litigants to use care to avoid instituting corporate reorganization proceedings without the consent of the secured creditors in cases in which the available free assets or income are insufficient to meet the necessary costs of administration in event reorganization fails. Good faith in filing the petition is directly involved in such circumstances. I know of no valid reasons for a law which would permit the expenses of an abortive reorganization proceeding to be visited upon the holder of a valid preexisting lien without his consent or fault."

Even if there were no authorities on the issue here presented, it would most obviously be an injustice under the facts of this case to charge appellant with the administration expenses resulting from the reorganization proceeding. The appellant loaned money to the debtor

and received notes secured by deeds of trust on the debtor's real property. Upon default it sought to pursue its legal remedies. The debtor thwarted the appellant by filing a petition for reorganization and having the sale of debtor's property stayed. As a result, appellant has been unable to realize on the security. Even now it is tied up in a bankruptcy proceeding.

Despite the efforts of the appellant to have the proceedings dismissed, the trustee and his attorney kept the proceedings going [Tr. p. 26, lines 5-17, 20-22; p. 27, lines 6-14]. As a result, the security has depreciated [Tr. p. 64, lines 10-14], some of it has been stolen or removed [Tr. p. 64, lines 4-10], and it is under threat of condemnation [Tr. p. 63, line 21, to p. 64, line 4]. Although the deeds of trust secure notes in the sum of $225,000.00, the value of the property secured had been reduced to approximately $120,000.00 at the time the trustee filed his report [Tr. p. 65, lines 1-4].

The debtor was hopelessly insolvent. There was no going business. It had no funds [Tr. p. 57, line 6; p. 93, line 15]. All it had was a half-completed hotel [Tr. p. 63, lines 21-24]. Even the Court below recognized during the course of the proceedings that a plan of reorganization was not likely to be formulated [Tr. p. 20, lines 9-23; p. 24, lines 10-12; p. 33, lines 13-15]. Congress never intended that corporations, fit subjects for liquidation should be reorganized. (*Magidson v. Duggan,* 212 F. 2d 708, 760; *Price v. Spokane,* 97 F. 2d 237.)

If, under the facts of this case, a secured lienholder is charged with the allowances made by reason of the abortive proceeding, what good is a mortgage or a deed of trust? Would any lender be willing to lend money on

the security of a mortgage if the mortgagee may have to foot the bill for an abortive reorganization proceeding?

The appellant is an institution lending the money of its investors. Its loans are secured by deeds of trust on real property. Surely, its security should not be impaired by making the allowances of a proceeding of this nature a prior lien. The appellant believes that if this Court should rule that appellant's contention is correct, such a ruling will go far in preventing the institution of ill-fated reorganization proceedings, particularly in Nevada where a considerable number have been filed within the last year.

Conclusion.

For the reasons stated herein, appellant respectfully submits that the order of January 24, 1957, making the allowances to the trustee and the attorney for the trustee a first lien on the property of the debtor, be reversed.

Respectfully submitted,

Samuel S. Lionel,

Attorney for Appellant.